

Audit Report



THE AIR FORCE CONTRACT AUDIT FOLLOWUP SYSTEM

Report No. 00-003

October 4, 1999

Office of the Inspector General
Department of Defense

Additional Copies

To obtain additional copies of this audit report, contact the Secondary Reports Distribution Unit of the Audit Followup and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or FAX (703) 604-8932 or visit the Inspector General, DoD, Home Page at www.dodig.osd.mil.

Suggestions for Audits

To suggest ideas for or to request future audits, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, Virginia 22202-2884

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@dodig.osd.mil; or by writing to the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

AFFARS
DFARS
FAR
OIG

Air Force Federal Acquisition Regulation Supplement
Defense Federal Acquisition Regulation Supplement
Federal Acquisition Regulation
Office of Inspector General



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

October 4, 1999

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Audit Report on the Air Force Contract Audit Followup System
(Report No. 00-003)

We are providing this report for review and comment. The Air Force did not respond to the draft report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request the Air Force provide comments by October 29, 1999.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Wayne K. Million, at (703) 604-9312 (DSN 664-9312) (wmillion@dodig.osd.mil) or Mr. Michael A. DiRenzo, at (703) 604-9314 (DSN 664-9314) (mdirenzo@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 00-003
(Project No. 9CG-9011)

October 4, 1999

The Air Force Contract Audit Followup System

Executive Summary

Introduction. The Office of Management and Budget Circular A-50, "Audit Followup," prescribes policies and procedures for executive agencies to establish followup systems to ensure prompt and proper resolution and implementation of findings and recommendations in Federal audit reports. The DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports, implements the Office of Management and Budget Circular A-50 and establishes DoD policies, responsibilities, reporting requirements, and followup procedures for contract audit reports. Secretaries of the Military Departments and Directors of the Defense agencies are required by DoD Directive 7640.2 to maintain adequate followup systems and establish procedures to monitor and ensure the proper, timely resolution and disposition of contract audit reports. Also, the directive requires the Office of the Inspector General, DoD, to monitor and evaluate contract audit followup systems and program performance within the Department. This audit was performed as part of those responsibilities under the directive.

Objectives. The overall audit objective was to evaluate the Air Force contract audit followup system. Specifically, we reviewed the completeness and accuracy of the Air Force contract audit followup system that contained 302 audit reports with \$1.1 billion costs questioned. We evaluated whether contracting officers took timely and appropriate actions on contract audit recommendations. Also, we reviewed the management control program applicable to the stated objectives.

Results. We reviewed 100 statistically sampled audit reports with \$460 million costs questioned. The Air Force contract audit followup system was generally accurate and complete. However, contracting officers experienced delays of 9 to 60 months in settling 12 overage contract audit reports. As a result, contracting officers sustained a significantly lower percentage of costs questioned, 33.5 percent, for reports over 2 years old, versus sustaining 97 percent for reports settled within 1 year and 81 percent for reports settled within 2 years (finding A).

Contracting officers did not issue demand letters on seven defective pricing settlements involving \$1.6 million in contract overpayments and interest. Consequently, overpayments and associated interest were not collected in a timely manner in all cases (finding B).

Summary of Recommendations. We recommend that the Deputy Assistant Secretary of the Air Force (Contracting) require quarterly reporting on the status of all open contract audits over 1 year old, and establish a process for contracting offices to share their best practices for monitoring audit reports. We also recommend that each

contracting office implement procedures requiring that a separate demand letter be issued in accordance with the Federal Acquisition Regulation and DoD policy prescribed by the Director, Defense Procurement, and that debt collection actions be reviewed as part of the business clearance process.

Management Comments. We provided a draft of this report on July 9, 1999. The Air Force did not respond to the draft report. Therefore, we request the Air Force provide comments by October 29, 1999.

Table of Contents

Executive Summary	i
Introduction	
Background	1
Objectives	1
Findings	
A. Processing Contract Audit Reports	2
B. Demand Letters on Contract Debts	6
Appendixes	
A. Audit Process	
Scope	9
Methodology	9
Management Control Program	10
Summary of Prior Coverage	11
B. Director, Defense Procurement Guidance on Contract Debt Collection	12
C. Report Distribution	16

Background

Contract Audit Followup. The Office of Management and Budget Circular A-50, "Audit Followup," prescribes policies and procedures for executive agencies to establish followup systems to ensure prompt and proper resolution and implementation of findings and recommendations in Federal audit reports. The DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," implements the Office of Management and Budget Circular A-50 and establishes DoD policies, responsibilities, reporting requirements, and followup procedures for contract audit reports. Secretaries of the Military Departments and Directors of the Defense agencies are required by DoD Directive 7640.2 to maintain adequate followup systems and establish procedures to monitor and ensure the proper, timely resolution and disposition of contract audit reports. Also, the directive requires the Office of the Inspector General, DoD, to monitor and evaluate contract audit followup systems and program performance within the Department. This audit was performed as part of those responsibilities under the directive.

Air Force Implementation. The Air Force has established policies and procedures which implement the DoD Directive 7640.2 requirements to establish certain responsibilities, reporting requirements, and followup procedures for contract audit reports. The Air Force contract audit followup policy and procedures are contained in the Air Force Federal Acquisition Regulation Supplement (AFFARS) 1.5315.491, "Follow-up on contract audit reports."

Objectives

The overall audit objective was to evaluate the Air Force contract audit followup system. Specifically, we reviewed the completeness and accuracy of the Air Force contract audit followup system that contained 302 contract audit reports with \$1.1 billion in costs questioned. Also, we reviewed whether contracting officers took timely and appropriate action on contract audit recommendations. We reviewed the management control program as it related to the other audit objectives.

A. Processing Contract Audit Reports

The Air Force contract audit followup system was generally accurate and complete. However, contracting officers experienced delays of 9 to 60 months in settling 12 overage contract audit reports that questioned \$19 million. The delays occurred because management lacked adequate oversight and controls to ensure the proper and timely resolution and disposition of contract audit reports. As a result, contracting officers sustained a lower percentage of costs questioned.

Criteria for Managing the Contract Audit Followup Program

The DoD Appropriations Act of 1981 (Public Law 96-527) and the Office of Management and Budget Circular A-50 "Audit Followup," require resolution of contract audit reports, other than preaward reports, within 6 months of report issuance. DoD Directive 7640.2 prescribes the DoD management responsibilities, and resolution and disposition standards for contract audits.

Management Responsibilities. Secretaries of the Military Departments and the Directors of Defense agencies are required by DoD Directive 7640.2 to:

- direct periodic evaluations of their followup systems to determine whether the systems are adequate and result in timely resolution and disposition of audit reports;
- establish procedures to maintain up-to-date records on all reportable contract audit reports from receipt through disposition;
- establish procedures to monitor and ensure the proper and timely resolution and disposition of contract audit reports.

Resolution Standard. The directive includes the Federal requirement that contract audit reports should be resolved within 6 months of issuance. For contract audits, resolution is the point where the auditor and contracting officer agree on the action to take on report findings and recommendations, or in the event of disagreement, when the contracting officer determines a course of action after following the DoD component documentation and review procedures.

Disposition Standard. The directive requires that disposition take place as soon as possible after resolution but no later than 12 months after report issuance. In accordance with DoD policy, an audit report is "overage" if it is still open over 12 months after it was issued.

Air Force Policies and Procedures. Supplemental Air Force guidance on resolution and disposition is found in AFFARS 1.5315.491, "Followup on contract audit reports." The AFFARS 1.5315.491-7, "Disposition of contract audit reports," states:

(a) reportable contract audits should normally be disposed of within 12 months after issuance. Overaged audit reports shall receive heightened management attention including, if necessary, the assignment of additional resources.

Timeliness of Contracting Officer Actions

We reviewed 100 statistically sampled audit reports with \$460 million costs questioned. Contracting officers did not take timely actions on 12 audit reports causing delays of up to 60 months. For example, audit report number 4701-92G42097019-S1 on Rockwell International with questioned costs of \$5 million was issued February 11, 1994. No action was taken on the report until 5 years later, February 11, 1999, when the contracting officer began developing a plan to settle the audit issues. This action coincided with the date of our audit visit to this office. For audit report number 3131-92P42010008-S1 on Martin Marietta, issued September 23, 1996, questioning \$9.2 million, the contractor responded to the report December 18, 1996. However, no action was taken on the contractor's response until October 23, 1998, almost 2 years later. Table 1 shows the 12 audit reports with lengthy delays.

Table 1. Audit Reports with Lengthy Delays			
Audit Report Number	Contractor	Costs Questioned	Delay (Months)
1731-89Z42097018-S1	General Electric	\$1,031,935	11
1441-94A42097-003	Lockheed Corp.	173,570	52
3421-92A42097-007	McDonnell Douglas	190,061	23
4171-93H42040-002	Hughes Aircraft Co.	434,205	27
4341-94D42098-056076	Lockheed Corp.	49,426	58
4471-91A42097040-S1	Rockwell International	504,000	58
4701-92G42097019-S1	Rockwell International	5,119,000	60
6351-92F42040-003	Link Flight Systems	340,242	52
3131-94B42097-003-S1	Martin Marietta	945,856	31
3131-94B42010-003-S4	Martin Marietta	469,153	11
3131-94B42010-002-S2	Martin Marietta	614,051	9
3131-92P4201008-S1	Martin Marietta	9,233,603	22
Total		\$19,105,102	

Management Controls Over Contract Audit Followup

The Air Force experienced delays in processing audit reports because it did not have an effective high level management process to monitor contracting officer actions and assign adequate staff to ensure timely actions were taken on contract audit recommendations. Our review showed that some contracting offices were more efficient than others in processing audit reports. Contract managers who used automated tracking and reporting systems were able to monitor contracting officers' progress in settling reports more effectively. These managers could

identify lengthy delays or periods of inactivity. For example, Ogden Air Logistics Command used an automated tracking system to track audit reports. When an audit report arrived, it was immediately entered into the system and assigned to a pricing analyst. The pricing analyst tracked all actions on the report using the automated system. This system provided instant report status, allowing contract managers to immediately determine if there were delays, which enabled them to take appropriate action. Ogden Air Logistics Command has been using this system for about 6 years. The Aeronautical Systems Center, at Wright-Patterson Air Force Base, Ohio was experiencing significant processing delays and implemented a similar automated tracking system within the last year. To ensure that all contracting offices are processing audit reports efficiently, the Air Force must develop a procedure for reviewing the status of overage audit reports at the senior management level. Also, the Air Force should establish a process for contracting offices to share their best practices for monitoring audit reports. By sharing ideas among contracting offices, the Air Force can become more effective in reducing processing delays.

Sustention of Costs Questioned

Settling audit issues in a timely manner could result in a higher sustention rate of costs questioned. Air Force contracting officers sustained a significantly higher percentage of costs questioned for reports settled within 1 or 2 years versus those that were over 2 years old. See Table 2 for the results from the semiannual periods ended March 31 and September 30, 1998.

Table 2. Sustention Rate of Audit Reports (costs in millions)				
Age of Report	Number of Reports	Costs Questioned	Costs Sustained	Sustention Percentage
1 year	23	\$56.3	\$54.6	97.0
2 years	13	3.7	3.0	81.1
over 2 years	25	67.8	22.7	33.5
Total	61	\$127.8	\$80.3	62.8

The Air Force could improve its potential for sustained costs by minimizing processing delays given the higher sustention rate for audit reports closed within the prescribed time frame of 1 year. Our review included a universe of 204 open reports with \$1 billion costs questioned. By settling reports faster, Air Force contracting officers could sustain a significantly higher percentage of the \$1 billion costs questioned on the remaining open reports.

Recommendations

A. We recommend that the Deputy Assistant Secretary of the Air Force (Contracting):

1. Require contracting offices to submit quarterly reports on the status of all open contract audit reports that are more than 1 year old.
2. Develop a process for Air Force contracting offices to share their best practices for monitoring the status of contract audit reports.

Management Comments Required

The Air Force did not comment on the draft report. We request that the Air Force provide comments on the final report.

B. Demand Letters on Contract Debts

Contracting officers did not issue proper demand letters in 7 of 21 cases when they were required. The letters were not issued because contracting officials were not aware of the requirement to issue separate demands for payment when they reached bilateral agreement with contractors. As a result, proper demand letters were not issued on seven defective pricing settlements involving \$1.7 million in contract overpayments and interest and, in some cases, this caused collection delays.

Criteria for Contract Debt Collection

The Truth in Negotiations Act. The Truth in Negotiations Act (TINA), 10 United States Code (U.S.C.), 2306a, requires Government contractors to submit cost or pricing data, and to certify that such data are accurate, complete, and current upon agreement on the contract price. The TINA also requires a downward adjustment to the contract price, including profit or fee, if the price was increased because the contractor submitted defective cost or pricing data, and the Government relied on the defective data when negotiating the contract price.

The TINA requires contractors to pay interest on overpayments because of defective cost or pricing data. Interest is due from the time of overpayment to the time of repayment. The underpayment rates are prescribed by the Secretary of the Treasury under 26 U.S.C. 6621.(a)(2) of the Internal Revenue Code of 1986. The statutory requirements on interest and penalties for overpayments apply to negotiated contracts that were awarded on or after November 8, 1985, as well as modifications issued after that date. Contracts that were awarded before November 8, 1985 accrued interest 30 days after contractor receipt of the demand letter, not from the date the overpayment was made.

Federal Acquisition Regulation (FAR) 32.6, "Contract Debts." The FAR, subpart 32.6, prescribes policies and procedures for the Government's actions in ascertaining and collecting contract debts. The FAR 32.610 requires that a demand for payment shall be made as soon as the responsible official has computed the amount of refund due. The FAR also prescribes the required elements to be included in a demand letter.

DoD Policy for Contract Debt Collections. The Director, Defense Procurement issued policy guidance, "Contract Debt Collection," January 13, 1995. See Appendix B for a copy of the guidance. The policy guidance states:

2. Demands for payment shall be issued as business letters; they shall not be incorporated into contract modifications
3. Even though a debt will be the subject of a bilateral modification, the contracting officer must still issue a demand for payment. The

best practice is to send the demand letter with the bilateral modification to the contractor for signature.

Air Force Policy on Contract Debt Collection. The AFFARS 15315.491-8, "Recovery of Funds," implements regulatory policies to collect contract debts resulting from contract audit recommendations. The AFFARS states:

Any amount due the Government as a result of a contract audit is to be determined by the contracting officer either negotiating a settlement with the contractor or issuing a unilateral decision when negotiations are unsuccessful. Upon completion of either action, the contracting officer shall make a prompt written demand for payment, citing the amount due, with a copy of the demand letter provided to the payment office cited in the contract.

Collection of Contract Debts

Table 3 shows the seven cases where contracting officers did not issue proper demand letters in accordance with prescribed policies.

Table 3. Proper Demand Letters Not Issued		
Audit Report Number	Contractor	Amount
3131-94B42097-003-S1	Martin Marietta	\$ 166,724
3131-94B42010-003-S4	Martin Marietta	127,625
3131-94B42010-002-S2	Martin Marietta	156,640
3121-95G420130-011-S1	International Business Machine	156,354
2201-97C42000-002	AIL System Corporation	22,826
4381-96C42000-012-S2	Boeing Defense & Space Group	37,240
6261-96A42000-007	Tri-Cor Industries	1,000,000
Total		\$1,667,409

Issuance of Demand Letters. In the cases where separate demand letters for payment were not issued but were inappropriately included in the contract modifications, contracting officers stated that they believed it was not necessary to issue a separate demand letter when they reached a bilateral agreement with the contractors. They were not aware of policy guidance issued by the Director, Defense Procurement. The guidance prescribes that the demand letter should be issued as a business letter and not incorporated into the contract modification. We provided copies of the policy guidance to the contracting offices we visited.

Some contracting officers believed that including the demand for payment in the contract modification would expedite the debt collection process. Including the demand in the contract modification versus issuing a proper demand letter did not result in expedient debt collections. For example, to settle the defective pricing cases for Martin Marietta audit reports 3131-94B42010-002-S2 and 3131-94B42010-003-S4, the contractor sent two letters to the contracting office on January 13, 1997. The letters requested that the contracting officer issue

written demands for payment of amounts due resulting from defective pricing allegations. The contracting officers never issued the demand letters. The overpayment amounts were not collected until contract modifications were issued in December 1997. Nonissuance of the demand letters caused a 12-month delay in recovering the overpayments from the contractor.

Contracting officers are required to issue demand letters as soon as amounts due are determined to protect the Government's interests. The letters ensure that debts are properly recorded and collected. The Air Force lacked adequate procedures to ensure that contracting officers were complying with DoD policy, regulations, and procedures when collecting contract debts.

Recommendations

B. We recommend that the Deputy Assistant Secretary of the Air Force (Contracting):

1. Direct contracting offices to implement debt collection procedures through issuance of a separate demand letter in accordance with the Federal Acquisition Regulation and DoD policy prescribed by the Director, Defense Procurement.
2. Develop procedures to review debt collection actions as part of the business clearance process.

Management Comments Required

The Air Force did not comment on the draft report. We request that the Air Force provide comments on the final report.

Appendix A. Audit Process

Scope

Work Performed. We reviewed the adequacy of Air Force management policies and procedures implementing the contract audit followup system that contained 302 audit reports with \$1.1 billion in costs questioned for the semiannual reporting periods ended March 31, 1998 and September 30, 1998. We reviewed whether contracting officers took timely and appropriate action on contract audit recommendations contained in 100 statistically sampled audit reports with \$460 million costs questioned. We reviewed contract audit reports and contract file documentation to evaluate compliance with regulations and DoD policies.

DoD-Wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objectives and goals:

Objective: Fundamentally reengineer DoD and achieve a 21st century infrastructure.

Goal: Reduce costs while maintaining required military capabilities across all DoD mission areas. (DoD-6)

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the DoD. This report provides coverage of the Defense Contract Management high risk area.

Methodology

To evaluate the Air Force contract audit followup system, we verified the accuracy of reported data, evaluated timeliness and appropriateness of actions taken on contract audit reports, and evaluated the adequacy and effectiveness of management controls over the settlements. Our field visits and other followup actions included review of the following:

- existing statutory provisions, regulations, and Air Force guidelines on contract audit followup;
- contract file documentation, such as price-reduction modifications, contracting officer final decisions, demand letters, prenegotiation and postnegotiation business clearances, followup correspondence, and memorandums for record;
- methods of recovery and the status of recovery actions;

-
- assessment and collection of statutory interest;
 - audit reports, supplements thereto, audit rejoinders, and other advisory memorandums; and
 - communication and correspondence between contracting officers, contractors, contract auditors, and payment or accounting and finance offices.

Use of Computer-Processed Data. To achieve the audit objectives, we relied on computer-processed data contained in the OIG, DoD, Contract Audit Reporting Tracking System. The Contract Audit Reporting Tracking System is a database comprised of reportable audits submitted semiannually by DoD Components to the OIG, DoD. We performed a limited reliability assessment of the database to develop a universe of audit reports for the Air Force. We determined that the computer-processed data is sufficiently reliable to be used in meeting the audit objectives. During the field work, we performed further data validation by tracing reported data from the Contract Audit Reporting and Tracking System to source documentation, such as audit reports, business clearance memorandums, and other contract file documentation.

Statistical Sampling Methodology. The OIG, DoD, Quantitative Methods Division randomly selected a sample of 100 contract audit reports from the Air Force contract audit followup database. The audit universe included 302 contract audit reports, contained in the Air Force contract audit followup database semiannual report periods, ended March 31, 1998 and September 30, 1998. Of the randomly selected audit reports, 50 were open reports with \$429.7 million costs questioned and 50 closed reports with \$30.3 million costs questioned, of which \$19.8 million were sustained.

Use of Technical Assistance. An Operations Research Analyst from the Quantitative Methods Division provided technical assistance by developing and analyzing the selected sample.

Audit Period, Dates, and Standards. We conducted this program audit from December 1998 through June 1999, in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD.

Contacts During the Audit. We visited or contacted individuals and organizations within Air Force. Further details are available on request.

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD Components to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the Air Force management controls over the contract audit followup system. Specifically, we reviewed the Air Force management controls for maintaining a complete and accurate contract audit followup database, and ensuring the timely and appropriate processing of contract audit report recommendations.

Adequacy of Management Controls. The Air Force management controls were adequate in that we identified no material management control weaknesses. However, implementation of Recommendations A and B will improve the Air Force contract audit followup program for processing contract audit reports and collecting contract debts.

Summary of Prior Coverage

Inspector General, DoD, Audit Report No. 99-048, "Dispositioned Defective Pricing Reports at the Naval Air Systems Command," December 8, 1998.

Inspector General, DoD, Policy and Oversight Report No. 98-063, "Dispositioned Defective Pricing Audit Reports at the U.S. Army Aviation and Troop Command," December 23, 1997.

Inspector General DoD, Policy and Oversight Report No. 97-045, "Evaluation of Dispositioned Defective Pricing Audit Reports at the Warner Robins Air Logistics Center," September 24, 1997.

Appendix B. Director, Defense Procurement Guidance on Contract Debt Collection



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

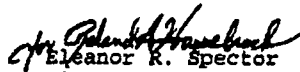


JAN 13 1995

MEMORANDUM FOR DIRECTORS OF DEFENSE AGENCIES
DEPUTY FOR ACQUISITION AND BUSINESS MANAGEMENT,
ASN(RD&A)/ABM
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE
(CONTRACTING), SAF/AQC
DIRECTOR, PROCUREMENT POLICY, ASA(RD&A)/SARD-PP
DEPUTY DIRECTOR (ACQUISITION), DEFENSE LOGISTICS
AGENCY

SUBJECT: Contract Debt Collection

The Inspector General has identified a number of problems associated with the contract debt collection process. In order to ensure there is no confusion about procedures that must be followed, we have prepared the attached guidance. Please ensure your contracting officers are furnished copies.


Eleanor R. Spector
Director, Defense Procurement

Attachment



CONTRACT DEBT COLLECTION

I. DETERMINATION OF CONTRACT DEBTS

A. RESPONSIBILITIES:

The contracting officer is responsible for determining the principal amount of most contract debts. The Comptroller of the Department or agency concerned is responsible for accounting for debts, deciding on deferments, and collecting contract debts.

B. ISSUANCE OF DEMANDS:

1. Demands for payment shall be issued as soon as the contracting officer has determined the amount of refund due. Such a determination is a final decision, and issuing "preliminary" decisions as a basis for demands for payment is prohibited. If the contracting officer does not know the full extent of a debt (e.g., when there is a default termination), demand the amount known to be owed. Inform the contractor of the incremental nature of the demand, and demand the remainder when the full amount becomes known.

2. Demands for payment of debts shall be issued as business letters; they shall not be incorporated into contract modifications. It is acceptable to include the demand in the contracting officer's final decision. The demand shall comply with the requirements in FAR 32.610(b), and any other requirements of the FAR or DFARS related to the specific type of debt (e.g., FAR 15.804-7(b)(7) for defective pricing and FAR 30.602-2(c) for Cost Accounting Standards (CAS) noncompliances). The demand shall direct the contractor to make payment for the debt to the payment office or, in the case of terminations for default, to the accounting office.

3. Even though a debt will be the subject of a bilateral modification, the contracting officer must still issue a demand for payment. The best practice is to send the demand letter with the bilateral modification to the contractor for signature.

4. The contracting officer shall send a copy of each demand to the payment office and request acknowledgment of receipt. Contracting officers shall provide the payment office with a distribution of the principal amount of the debt by appropriation, preferably attached to the payment office copy of the demand letter. The deobligation of funds on an SF 30 (Amendment of Solicitation/Modification of Contract) does not provide sufficient notice of debt disposition.

ATTACHMENT

5. The contracting officer shall follow-up periodically with the payment office to ensure that contract debts have been collected and credited to the proper appropriations.

C. DEBTS ARISING FROM DEFECTIVE PRICING OR CAS NONCOMPLIANCES:

1. Unlike most contract debts which accrue interest only if not paid within 30 days of the date of the contracting officer's demand, debts arising from defective pricing and CAS noncompliances have interest charges from the date of overpayment by the Government to the date of repayment by the contractor (see FAR 15.804-7(b)(7) and 30.602-2(c)(2)). Therefore, when issuing a demand letter, the best practice is to identify separately the overpayment principal amount, the interest amount calculated through a specified date, and any penalty amount. The demand letter should also include a statement that interest will continue to accrue until repayment is made. A copy of this demand letter should be sent to the payment office. The payment office will refund interest and penalty amounts to the U.S. Treasury, while principal amounts will be credited to the original appropriation or to Miscellaneous Receipts.

2. The amount of the contract price reduction and the contract debt will not be the same. For example, if defective pricing is found after partial deliveries have been paid for by the Government, the contracting officer must calculate the debt--i.e., the amount of overpayment, interest on the overpayment through a specified date, and any penalty amount. The contract price will be reduced by the total amount of defective pricing determined by the contracting officer.

3. Interest and penalty assessments for defective pricing and CAS noncompliances are required by statute. These amounts cannot be negotiated away in "bottom line" settlements, and contracting officers are not authorized to waive these charges or offset them against amounts owed the contractor. Contracting officers may not accept credits or adjustments on contracts not affected by defective pricing or CAS noncompliances instead of obtaining price reductions on the affected contracts. Such action could result in illegal augmentation of appropriations.

II. COMPROMISE, WAIVER, OR SUSPENSION OF DEBTS, INTEREST, OR PENALTIES

A. AUTHORITY:

Contracting officers do not have the authority to compromise, waive, or suspend collection of a debt. Any decision to suspend or defer collection action, accept an installment payment arrangement, or compromise the amount of the debt must be

made by the Contract Financing Office or, in some situations, by the General Accounting Office. Contractor requests for any type of deferment or compromise of a debt should be handled expeditiously in accordance with the procedures at FAR 32.613, 32.616, and DFARS 232.616. The contracting officer shall forward deferment requests to the Contract Financing Office of the Department or agency for a decision on granting the deferment in accordance with DFARS 232.610(b)(3). Contract Financing Offices are set forth at DFARS 232.108.

B. PAYMENT OF DEBTS:

1. The contractor shall be required to liquidate debts either by cash payment in a lump sum on demand, or by credit against unpaid bills due the contractor, unless an agreement has been entered into to defer collection (see FAR 32.606(d)). A credit memorandum (also known as a credit invoice) is a request by the contractor that the Government collect the debt by offset against unpaid bills due the contractor. Such requests should be forwarded to the payment office. Upon receipt of a credit memorandum, the payment office will offset the debt against current invoices due and payable. If the debt is not immediately and fully collected by that offset, the contractor is still in debt for the remainder, and interest still accrues. The payment office should notify the contractor of the continued existence of the debt and the accruing interest on the unpaid balance.

2. If the contracting officer receives the contractor's check, it should immediately be sent to the payment office, with a request for confirmation of receipt.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Deputy Under Secretary of Defense (Installations)
Director, Defense Procurement
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Assistant Secretary of the Air Force (Acquisition)
Deputy Assistant Secretary of the Air Force (Contracting)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform

Audit Team Members

The Contract Management Directorate, Office of the Assistant
Inspector General for Auditing, DoD, prepared this report.

Paul J. Granetto
Wayne K. Million
Michael A. DiRenzo
Kimberly A. Gray
Veronica G. McCain
Tina S. Leach
Paul M. Gach